

# Individual State Agency Fiscal Note

<b>Bill Number:</b> H 1547	<b>Bill Title:</b> AN ACT Relating to investing in Washington families and creating a more progressive tax system in Washington by enacting an excise tax on the sale or exchange of certain capital assets	<b>Agency:</b> 140 Department of Revenue
<b>Part I: Estimates</b> <input type="checkbox"/> No Fiscal Impact		

## Estimated Cash Receipts to:

Fund	Fiscal Year 2022	Fiscal Year 2023	2021-2023 Total	2023-25 Biennium	2025-27 Biennium
Educ Legacy Trust NEW		530,000,000	530,000,000	1,170,000,000	1,266,000,000
GF-State Business and Occupation Tax		(77,000,000)	(77,000,000)	(171,000,000)	(185,000,000)
Workforce Educ Invest Acct Business and Occupation Tax		(8,000,000)	(8,000,000)	(18,000,000)	(20,000,000)
Total		445,000,000	445,000,000	981,000,000	1,061,000,000

## Estimated Expenditures from:

	Fiscal Year 2022	Fiscal Year 2023	2021-2023 Total	2023-25 Biennium	2025-27 Biennium
<b>FTE Staff Years</b>	15.44	24.3	19.87	19.2	15.7
<b>Fund</b>					
GF-State 001	2,561,900	4,334,200	6,896,100	6,948,100	4,211,600
Total	2,561,900	4,334,200	6,896,100	6,948,100	4,211,600

*The revenue and expenditures estimates on this page represent the most likely fiscal impact. Factors impacting the precision of these estimates, and alternate ranges (if appropriate), are explained in Part II.*

Check applicable boxes and follow corresponding instructions:

- ☒ If fiscal impact is greater than \$50,000 per fiscal year in the current biennium or in subsequent biennia, complete entire fiscal note form Parts I-V.
- ☐ If fiscal impact is less than \$50,000 per fiscal year in the current biennium or in subsequent biennia, complete this page only (Part I).
- ☐ Capital budget impact, complete Part IV.
- ☐ Requires new rule making, complete Part V.

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## **Part II: Narrative Explanation**

### **II. A - Brief Description Of What The Measure Does That Has Fiscal Impact**

NOTE: This fiscal note reflects language in House Finance Striker 5096-S.E AMH FIN H1547.5, 2021 Legislative Session.

#### **CURRENT LAW:**

There is no capital gains tax in Washington State.

#### **PROPOSAL:**

This fiscal note reflects a striking amendment to Engrossed Substitute Senate Bill (ESSB) 5096 as passed out of the Senate on March 6, 2021, and makes the following changes:

- Revises "intent" language.
- All revenues are deposited to the Education Legacy Trust Account.
- Removes the exemption for sales of controlling interests which are subject to real estate excise tax (REET).
- Provides an exemption for the sale of an interest in a privately-held entity to the extent that capital gains or losses from such sales are directly attributable to the real estate owned by the entity.
- Provides an exemption for commercial fishing privileges.
- Clarifies that the total standard deduction, when used by married couples or domestic partners who file federal taxes separately, must total no more than \$250,000.

#### **Full description:**

Beginning January 1, 2022, an excise tax is imposed on the sale or exchange of long-term capital assets. Only individuals are subject to payment of the tax, which equals 7 percent multiplied by an individual's Washington capital gains.

After exempting certain capital gains based on the type of asset sold or exchanged, for all filers except married couples filing separately and registered domestic partners filing separately, a standard deduction of \$250,000 is available. For married couples filing separately and registered domestic partners filing separately, the combined standard deduction is limited to \$250,000. The standard deduction is adjusted annually for inflation.

#### **WASHINGTON CAPITAL GAINS**

The amount of Washington capital gains is computed by making certain adjustments to an individual's federal long-term net capital gains. Only adjusted capital gains from the sale or exchange of capital assets sourced in Washington are subject to the tax. Losses resulting from the sale or exchange of assets sourced elsewhere may not reduce the taxable amount.

#### **EXEMPTIONS BASED ON TYPE OF ASSET SOLD OR EXCHANGED**

The capital gains tax does not apply to the following:

- The sale or exchange of real estate transferred by deed, real estate contract, judgment, or other lawful instruments that transfer title to real property and are filed as a public record with the counties where the real property is located. "Real estate" means land and fixtures affixed to land. The term also includes used mobile homes, used park model trailers, used floating homes, and improvements constructed upon leased land.
- The sale or exchange of an interest in a privately-held entity to the extent that capital gains or losses from such sales or exchange are directly attributable to the real estate owned by the entity.
- The sale or exchange of assets under certain retirement savings vehicles.
- Capital gains from the sale or exchange of assets sold or exchanged under condemnation proceedings or imminent threat of condemnation.
- The sale or exchange of cattle, horses, or breeding livestock by farmers if more than 50 percent of the taxpayer's gross income is from farming or ranching.

- The sale or exchange of property depreciable under Internal Revenue Code section 167(a)(1) or that qualifies for expensing under Internal Revenue Code section 179.
- The sale or exchange of timber or timberland, or the receipt of Washington capital gains as dividends and distributions from real estate investment trusts derived from gains from the sale or exchange of timber or timberland.
- The sale or exchange of goodwill from the sale of an auto dealership licensed under chapter 46.70 RCW.
- The sale or exchange of commercial fishing privileges.

## DEDUCTIONS

**Qualified Family-Owned Small Business Deduction:** A deduction is provided for capital gains derived from the sale of substantially all of the assets of, or the transfer of substantially all of a person's interest in, a qualified family-owned small business. To qualify, a taxpayer or a family member must have materially participated in the operation of the business for at least five of the eight years preceding the sale or transfer. Sales or transfers to qualified heirs are exempt from the material participation requirement.

To qualify for the deduction, a taxpayer must meet several requirements.

- "Substantially all" means 90 percent.
- Sale of assets: The sale is of at least 90 percent of the fair market value of the assets of the business. Assets include real property, tangible personal property, and intangible property.
- Transfer of interest: The transfer must be of at least 90 percent of a person's interest in a business. E.g., a person owning 50 percent of the business must transfer at least 45 percent of the business ownership (i.e., 90 percent of their share).

**Qualified family-owned small business:**

- The taxpayer, or their family, owned or had a qualifying interest in the business for at least eight years immediately prior to the sale of assets or transfer of interest.
- During the eight-year period, there must be periods aggregating at least five years during which the taxpayer or a member of their family materially participated in the operation of the trade or business.
- Exception: The material participation requirement does not apply to sales of assets or transfers of interests to qualified heirs (certain family members of the taxpayer).
- The small business must have worldwide gross revenue of \$10 million or less for the 12 months immediately preceding the sale or transfer. This gross revenue limit is adjusted annually for inflation.

**Qualified interest:**

- Can be a sole proprietorship, or
- An interest in an entity carrying on a trade or business if at least:
  - 50 percent of the entity is owned by the taxpayer and/or members of the taxpayer's family,
  - 70 percent of the entity is owned by two families and at least 30 percent is owned by the taxpayer and/or their family,
- or
- 90 percent of the entity is owned by three families and at least 30 percent is owned by the taxpayer and/or their family.

**Legally prohibited amounts:** A deduction is allowed for amounts the state is prohibited from taxing under federal law or the constitutions of the United States or the state of Washington.

## CREDITS

**B&O tax credit:** A credit against the business and occupation (B&O) tax is allowed, to avoid taxing the same sale or exchange under both the B&O and capital gains taxes.

**Out-of-state credit:** A credit against the capital gains tax is allowed for the amount of capital gains taxes paid to another taxing jurisdiction on capital gains derived from sources within the other taxing jurisdiction to the extent the capital gains are included in the measure of the Washington capital gains tax.

## FILING DEADLINES

Washington capital gains tax returns, any required information returns, and payments are due at the same time that the taxpayer's federal income tax return for the taxable year is due. Individuals receiving a federal tax filing extension also qualify for a state capital gains tax filing extension, but the tax is still due on the original filing date.

## REVENUES

All revenues will be deposited to the Education Legacy Trust Account.

## EFFECTIVE DATE:

The bill takes effect 90 days after final adjournment of the session in which it is enacted.

## II. B - Revenue Impact

### ASSUMPTIONS:

- Approximately 7,000 taxpayers pay capital gains taxes for taxes due in 2023.
- The tax takes effect on January 1, 2022, and the first payments are due on or about April 17, 2023.
- Because we do not have federal tax return data on nonresident individuals, this fiscal estimate assumes that the long-term net capital gains reported on Washington residents' federal tax returns are equivalent to the Washington capital gains for all taxpayers, including nonresidents.
- Taxpayers may only consider losses allocated to the state under section 108 when calculating their adjusted capital gains and Washington capital gains. Losses not allocated to the state under section 108 cannot be used to reduce a taxpayer's adjusted capital gains. Limiting available losses to losses allocated to the state would have a minimal but positive impact on revenues. For the purpose of this estimate, we assume the impact is zero due to a lack of information about how gains and losses are allocated to the state in the data available.
- Decoupling the Federal Opportunity Zone program from the Washington capital gains tax will have a minimal but positive impact on revenues.
- Determining federal net long-term capital gains as if the alternative minimum tax did not exist will have a minimal but indeterminate impact on revenues.
- No estimated payments or withholdings are made during the year.
- For all asset types excluded from the tax, the percentage of a Washington taxpayer's gains resulting from sales or exchanges of these assets aligns with percentages reported in IRS / SOI statistical tables for all taxpayers nationwide.
- Future amounts of capital gains for Washington taxpayers equal the amounts reported in 2018 tax returns, adjusted by using forecasted rates of growth and decay.
- The ratio of the out-of-state credit to gross tax is the same for Tax Years 2017 and 2018.
- Compliance is 85 percent in the first year, 90 percent in the second year, and 95 percent thereafter.

For the purpose of the real estate exemption, we estimate the amount of corporate stock capital gains exempted using the following assumptions:

- 87 percent of corporate stock capital gains are associated with privately held firms.
- 89 percent of depreciable business assets held by C-corporations consists of real estate.
- The types of assets sold or exchanged for capital gains align with the types of assets held by all U.S. C-corporations for Tax Year 2013, and capital gains resulting from such exchanges are proportional to the assets sold or exchanged, across all types of assets. For instance, if 16 percent of C-corporation assets are real property, then 16 percent of corporate stock capital gains result from the sale or exchange of real property.

For the purpose of estimating the amount of pass-through capital gains exempted, we assume:

- The types of assets sold or exchanged for capital gains align with the types of assets held by all U.S. S-corporations and partnerships for Tax Year 2014, and capital gains resulting from such exchanges are proportional to the assets sold or exchanged, across all types of assets.
- Sales or exchanges from 89 percent of depreciable business assets consists of real estate improvements.

- Sales or exchanges from all real estate held by these entities are exempt.

Due to a lack of available information about the amount of goodwill associated with sales of franchised auto dealerships, we assume the amount of goodwill associated with the sale of a franchised auto dealership is:

- For pass-through capital gains, the amount of amortizable intangible assets held by businesses in the “Motor vehicle dealers and parts dealers” sector, and
- For “Other Assets” sold or exchanged for capital gains, we assume that 51 percent of sales or exchanges of such assets are exempt, rather than 50 percent. The Other Assets category is in IRS table 2A, listed in the Data Sources section.

For the purpose of estimating the amount of the \$250,000 standard deduction, we assume this amount is available for all filers.

For the purpose of estimating the amount of the qualified family-owned small business deduction, we assume:

- All Washington firms with \$10 million or less in annual gross revenue will qualify as a qualified family-owned small business. To the extent that capital gains are derived from either (1) the sale of substantially all of the fair market value of the assets of a qualified family-owned small business, or (2) the sale of substantially all of a taxpayer’s qualifying interest in a qualified family-owned small business, the capital gains from such a sale will qualify for a deduction.
- The percentage of all capital gains qualifying for the qualified family-owned small business deduction remains constant year-to-year. This assumption has the same revenue impact as annually inflating the gross revenue limitation would have.

B&O tax credit:

- Each taxpayer maximizes the amount of the credit by applying the standard exemption first to gains realized from personal sources, then applying any remainder to gains from business sources.
- 10 percent of taxable capital gains resulting from business activity in the finance sector is not subject to the B&O tax, because it comes from private equity firms and hedge funds, which qualify for the investment income deduction against the B&O tax.
- The Financial Institutions Surtax for the B&O tax remains in effect.

#### DATA SOURCES:

- Internal Revenue Service (IRS) - Individual income tax returns data, Tax Years 2017 and 2018.
- IRS: SOI Tax Stats - Sales of Capital Assets Report on Individual Tax Returns, Tables 2A and 1C, Tax Years 2008 to 2012.
- IRS Statistics of Income: Returns of Active Corporations, Form 1120S - Table 6.1. Balance Sheet and Income Statement Items, by Major Industry, Tax Year 2014.
- IRS Statistics of Income: Table 3. All Partnerships: Balance Sheets by Industrial Group, Tax Year 2016.
- IRS Statistics of Income: Table 5. Partnerships with Income (or Loss) Allocated to Partners, by Selected Industrial Group, Tax Year 2014.
- IRS Statistics of Income: Returns of Active Corporations, Form 1120 - Table 16. Balance Sheet, Income Statement, Tax, and Selected Other Items, by Major Industry, Tax Year 2013.
- Department of Revenue: Excise tax data, Calendar Year 2020, Q2, used to estimate effective B&O tax rates for finance sector firms.
- Department of Revenue: Excise tax data, Fiscal Year 2018, used to estimate percentage of gross revenues that come from small businesses.
- Personal Income Forecast (November 2020). This includes:
  - The U.S. Congressional Budget Office: Capital gains realizations forecast (all states), August 2020, used to grow capital gains amounts.
  - Economic and Revenue Forecast Council, November 2020, Seattle CPI-Urban (U.S. BLS) forecast, used to adjust amounts for inflation.

#### REVENUE ESTIMATES

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**TOTAL REVENUE IMPACT:**

State Government (cash basis, \$000):

FY 2022 -	\$ 0
FY 2023 -	\$ 445,000
FY 2024 -	\$ 473,000
FY 2025 -	\$ 508,000
FY 2026 -	\$ 522,000
FY 2027 -	\$ 539,000

Local Government, if applicable (cash basis, \$000): None

**II. C - Expenditure Impact**

**ASSUMPTIONS:**

- This estimate affects 7,000 taxpayers.
- Taxpayers will not be required to make estimated payments.

**FIRST YEAR COSTS:**

The Department will incur total costs of \$2,561,900 in Fiscal Year 2022. These costs include:

Labor Costs - Time and effort equates to 15.44 FTEs.

- Provide technical advice, interpretation and analysis for internal use during the implementation process.
- Program, setup, test and verify computer systems to accept taxpayer returns and other required information and process reporting information for collection, audit, and refund purposes.
- Develop training for processing and working with capital gains tax returns.
- Answer phone calls and counter inquiries on tax questions and tax return preparation from businesses, individuals, and accountants.
- Update and maintain hard copy and online educational and informational materials.
- Create a special notice and update website and published information.
- Respond to tax ruling requests and email inquiries.
- Adopt two new administrative rules.

Object Costs - \$606,600.

- Contract computer system programming.
- Purchase additional server equipment.
- Print and mail outreach materials, general correspondence and notices to paper filers.
- Legal assistance from the Office of the Attorney General.

**SECOND YEAR COSTS:**

The Department will incur total costs of \$4,334,200 in Fiscal Year 2023. These costs include:

Labor Costs - Time and effort equates to 24.3 FTEs.

- Provide technical advice and interpretation services for internal use.
- Ongoing programming and testing of computer systems.
- Ongoing training development and training for the new tax.
- Create returns and design and develop new templates and forms.
- Answer phone calls and counter inquiries on tax questions and tax return preparation from individuals and accountants.
- Update and maintain hard copy and online educational and informational materials.

- Respond to tax ruling requests and email inquiries.
- Establish new reporting accounts for capital gains taxpayers.
- Process paper returns and associated work items.
- Resolve error and out of balance returns, conduct desk audits, prepare refunds and assessments.
- Collect delinquent assessments as a result of return errors.
- Hear additional administrative reviews that provide taxpayers with an informal, non-adversarial dispute resolution process for the review of a disputed action by the Department, such as an assessment of taxes, notice of taxes due, denial of a refund request, or tax ruling.

Object Costs - \$1,737,500.

- Contract computer system programming.
- Purchase additional server equipment.
- Purchase additional scanning equipment.
- Acquire additional seat licenses for the Telephone Information Center.
- Print and mail a special notice to affected taxpayers.
- Print and mail outreach materials, general correspondence, notices and returns to paper filers.
- Acquire informational brochures.
- Background checks for employees working with Internal Revenue Service data.
- Legal assistance from the Office of the Attorney General.

### THIRD YEAR COSTS:

The Department will incur total costs of \$4,077,000 in Fiscal Year 2024. These costs include:

Labor Costs - Time and effort equates to 20.0 FTEs.

- Provide technical advice and interpretation services for internal use.
- Ongoing programming and testing of computer systems including receiving and processing Internal Revenue Service information for verification of reporting and tax discovery.
- Ongoing training for the new tax.
- Answer phone calls and counter inquiries on tax questions and tax return preparation from businesses, individuals, and accountants.
- Update and maintain hard copy and online educational and informational materials.
- Respond to tax ruling requests and email inquiries.
- Establish new reporting accounts for capital gains taxpayers.
- Process returns, payments and all associated work items, including issuing assessments for return errors and underpayments.
- Assist taxpayers with reporting questions and respond to inquiries via email, web message, and paper correspondence.
- Collect delinquent assessments as a result of return errors.
- Hear additional administrative reviews.

Object Costs - \$2,069,500.

- Contract computer system programming.
- Purchase additional server equipment.
- Print and mail outreach materials, general correspondence, notices and returns to paper filers.
- Acquire informational brochures.
- Background checks for employees working with Internal Revenue Service data.
- Legal assistance from the Office of the Attorney General.

### FOURTH YEAR COSTS:

The Department will incur total costs of \$2,871,100 in Fiscal Year 2025. These costs include:

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Labor Costs - Time and effort equates to 18.4 FTEs.

- Provide technical advice and interpretation services for internal use.
- Ongoing programming and testing of computer systems.
- Ongoing training for the new tax.
- Answer phone calls and counter inquiries on tax questions and tax return preparation from businesses, individuals, and accountants.
- Update and maintain hard copy and online educational and informational materials.
- Respond to tax ruling requests and email inquiries.
- Establish new reporting accounts for capital gains taxpayers.
- Process returns, payments and all associated work items, including issuing assessments for return errors and underpayments.
- Assist taxpayers with reporting questions and respond to inquiries via email, web message, and paper correspondence.
- Create a tax discovery process and use desk audits to assess discovered liabilities.
- Collect delinquent assessments as a result of return errors.
- Hear additional administrative reviews.

Object Costs - \$1,032,100.

- Contract computer system programming.
- Purchase additional server equipment.
- Print and mail outreach materials, general correspondence, notices and returns to paper filers.
- Acquire informational brochures.
- Warrant filing fees and postage for collection of additional delinquent accounts.
- Background checks for employees working with Internal Revenue Service data.
- Utilize locate and research services to verify reporting and tax discovery.
- Legal assistance from the Office of the Attorney General.

### Part III: Expenditure Detail

#### III. A - Expenditures by Object or Purpose:

	Fiscal Year 2022	Fiscal Year 2023	2021-2023 Total	2023-25 Biennium	2025-27 Biennium
Salaries and Wages	1,213,500	1,627,100	2,840,600	2,481,400	2,029,800
Benefits	436,700	585,800	1,022,500	893,300	730,800
Personal Service Contracts	500,000	1,500,000	2,000,000	3,000,000	1,000,000
Supplies & Material	263,400	370,000	633,400	514,700	400,800
Travel	300	600	900	600	600
Office Equipment	148,000	250,700	398,700	58,100	49,600
<b>Total</b>	<b>2,561,900</b>	<b>4,334,200</b>	<b>6,896,100</b>	<b>6,948,100</b>	<b>4,211,600</b>

#### III. B - FTE Detail:

Job Classification	Salary	FY 2022 FTEs	FY 2023 FTEs	2021 - 2023 Total	2023 - 2025	2025 - 2027
ADM ASST 3	43,392		.1	.05	.1	
COMMUNICATIONS CNSLT 4	64,332	.5	.5	.5		
CUSTOMER SERV SP2	39,528		.3	.15	.1	.1
EMS BAND 4	119,061	.01		.01		
EMS BAND 5	139,090	.01		.01		
EXCISE TAX EX 1	43,392		1	.5	1	1
EXCISE TAX EX 2	54,108		5	2.5	5	5
EXCISE TAX EX 3	59,688	1	1	1	1	1

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FISCAL ANALYST 3	55,524		.5	.25	.5	.5
IT APP DEV-JOURNEY	85,644	1	1	1	.5	.5
IT B A-JOURNEY	85,644	.5	.5	.5	.3	.3
IT PROJ MGT-JOURNEY	89,916	1	1	1	.5	.5
IT QA-JOURNEY	85,644	1.5	1.5	1.5	.8	.8
MGMT ANALYST4	70,956	3.62	3.7	3.66	2.4	1.8
MGMT ANALYST5	78,408	1.4	1.1	1.25	.4	.1
RECORDS MGMT SUPV	67,560		.2	.1		
REVENUE AGENT 4	64,332		.3	.15	.3	.3
TAX INFO SPEC 1	43,392		2.2	1.1	2.1	1
TAX INFO SPEC 4	64,332	.5	1	.75	1	.5
TAX POLICY SP 2	72,756	.01		.01		
TAX POLICY SP 3	82,344	2.63	2	2.32	1.8	1.1
TAX POLICY SP 4	88,644	.64	.4	.52	.4	.2
WMS BAND 2	89,018	1.1	1	1.05	1	1
WMS BAND 3	101,257	.02		.01		
<b>Total</b>		15.44	24.3	19.89	19.2	15.7

### III. C - Expenditures by Program (optional):

	Fiscal Year 2022	Fiscal Year 2023	2021-2023 Total	2023-25 Biennium	2025-27 Biennium
<b>Total</b>					

### Part IV: Capital Budget Impact

None.

### Part V: New Rule Making Required

Should this legislation become law, the Department will adopt two new rules under 458-20 WAC, one using the complex process and one using the standard process. Persons affected by this rule making would include Individuals meeting the threshold for reporting and/or paying the new capital gains tax.

**Revenue Impact Detail**

FUND	SOURCE	CODE	First Biennium		Second Biennium		Third Biennium	
			1st YEAR	2nd YEAR	3rd YEAR	4th YEAR	5th YEAR	6th YEAR
GF-State	Business and Occupation Tax	0105		(77,000,000)	(82,000,000)	(89,000,000)	(91,000,000)	(94,000,000)
Total				(77,000,000)	(82,000,000)	(89,000,000)	(91,000,000)	(94,000,000)
OTHER								
Educ Legacy Trust	NEW	0000		530,000,000	564,000,000	606,000,000	623,000,000	643,000,000
Workforce Educ Invest Acct	Business and Occupation Tax	0105		(8,000,000)	(9,000,000)	(9,000,000)	(10,000,000)	(10,000,000)
Total				522,000,000	555,000,000	597,000,000	613,000,000	633,000,000
Net				445,000,000	473,000,000	508,000,000	522,000,000	539,000,000

**Revenue Impact - by Biennium**

FUND	SOURCE	CODE	1st Biennium	2nd Biennium	3rd Biennium
GF-State	Business and Occupation Tax	0105	(77,000,000)	(171,000,000)	(185,000,000)
Total			(77,000,000)	(171,000,000)	(185,000,000)
OTHER					
Educ Legacy Trust	NEW	0000	530,000,000	1,170,000,000	1,266,000,000
Workforce Educ Invest Acct	Business and Occupation Tax	0105	(8,000,000)	(18,000,000)	(20,000,000)
Total			522,000,000	1,152,000,000	1,246,000,000
Net			445,000,000	981,000,000	1,061,000,000